Sunnhordland Kraftlag AS
Kingdom of Norway, Utilities

BBB+ POSITIVE

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	108.3x	-160.4x	-122.5x	203.5x
Scope-adjusted debt/EBITDA	0.4x	-0.7x	-0.5x	-0.4x
Scope-adjusted funds from operations/debt	244%	Net Cash	Net Cash	Net Cash
Scope-adjusted free operating cash flow/debt	193%	Net Cash	Net Cash	Net Cash

Rating rationale

The issuer rating reflects Sunnhordland Kraftlag AS' (SKL) standalone credit assessment of BBB and a one-notch uplift related to its government-related entity status. The Positive Outlook is driven by an increased probability of prolonged higher-than-historical power prices in the NO2 price region in Norway, which would bolster key credit metrics, supported by a robust performance from the company's hydropower assets.

SKL's business risk profile (assessed at BBB-) is supported by its efficient hydro power production (positive ESG factor) and above-average profitability compared to peers.

SKL's improved financial risk profile (A) reflects very strong end-2022 metrics. This will likely persist throughout our forecast, despite continued dividends, higher resource rent tax and increased investments.

Outlook and rating-change drivers

The Positive Outlook reflects further rating upside, driven by the possibility of prolonged higher-than-historical power prices in NO2. This will likely lead to a strong performance in SKL's efficient and flexible hydropower assets and a sustained net cash position in the medium term, given no unexpected acquisitions and/or extraordinary shareholder remuneration.

A rating upgrade could be warranted if credit metrics remained at their strong end-2022 levels, exemplified by a sustained net cash position. Albeit remote, an upgrade could also be warranted by an improvement in market position or diversification with still strong credit metrics.

A negative rating action, such as a revision of the Outlook to Stable, could be triggered if a net cash position became less likely. This could be driven by significantly lower-than-expected power prices, higher-than-expected capex, extraordinary dividends, or structural transactions that weigh on the company's financial risk profile.

Further rating downside could occur through a significant deterioration in credit metrics and/or loss of the company's status as a government-related entity.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
29 Nov 2023	Outlook change	BBB+/Positive
28 Nov 2022	Upgrade	BBB+/Stable
13 Dec 2021	Initial rating	BBB/Stable

Ratings & Outlook

Issuer	BBB+/Positive
Senior unsecured debt	BBB+

Analyst

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Related Methodologies

General Corporate Rating Methodology; October 2023

European Utilities Rating Methodology; March 2023

Government Related Entities Rating Methodology; July 2023

Related Research

European utilities: continued electricity price hedging promises producer gain, consumer pain, Apr 2023

Nordic utilities: north-south price gap benefits southern generators; TSOs also gain, Nov 2022

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Bloomberg: RESP SCOP

Rating and rating-change drivers

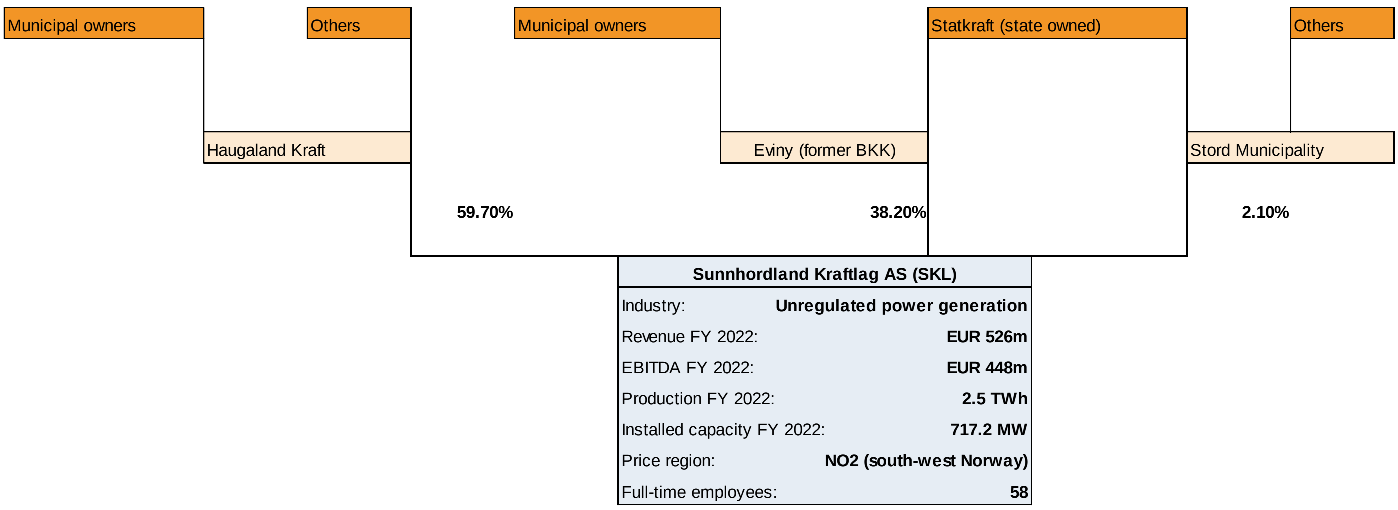
Positive rating drivers	Negative rating drivers
• Profitable, low-cost hydropower production (positive ESG factor) with high reservoir capacity and natural inflow from glaciers • Long-term, indirect municipality ownership justifying the status as government-related entity and a one-notch uplift to the standalone rating • Favourably located in the NO2 price region in Norway, which has higher spot prices than other price regions due its direct link to the UK and Continental Europe • Strong current and projected financial flexibility despite expectations of ambitious capex programme and substantial shareholder remuneration	• Low geographical and business diversification • High dependency on largest generating assets • Full exposure to volatile power prices through unhedged power production

Positive rating-change drivers	Negative rating-change drivers
• Net cash position sustained • Improved business risk profile, i.e. stronger market position, increased vertical integration or horizontal diversification, while keeping strong credit metrics (remote)	• Outlook revision to Stable: non-materialisation of net cash position, sustained. • Negative Outlook or downgrade: significant deterioration in credit metrics and/or loss of the company's status as a government-related entity.

Corporate profile

SKL is a municipally majority-owned Norwegian utility focused on environmentally friendly hydropower production in NO2. It is the majority shareholder in 13 hydro power plants, mainly located in the Rogaland and Vestland counties on the south-west coast of Norway. In addition, it has ownership interests in 10 other smaller power plants in the region. SKL is directly owned by utilities Haugland Kraft AS (59.7%) and Eviny AS (38.2%) and Stord Municipality (2.1%).

Figure 1: Simplified overview



Sources: SKL, Scope

Financial overview

				Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Scope-adjusted EBITDA/interest cover	5.7x	108.3x	-160.4x	-122.5x	203.5x	-294.0x
Scope-adjusted debt/EBITDA	10.9x	0.4x	-0.7x	-0.5x	-0.4x	-0.2x
Scope-adjusted funds from operations/debt	-14%	244%	Net Cash	Net Cash	Net Cash	Net Cash
Scope-adjusted free operating cash flow/debt	-33%	193%	Net Cash	Net Cash	Net Cash	Net Cash
Scope-adjusted EBITDA in NOK m						
EBITDA	120	1,771	4,861	1,956	1,906	1,673
Scope-adjusted EBITDA	**120**	**1,771**	**4,861**	**1,956**	**1,906**	**1,673**
Funds from operations in NOK m						
Scope-adjusted EBITDA	120	1,771	4,861	1,956	1,906	1,673
less: (net) cash interest paid	-21	-16	31	16	-9	6
less: cash tax paid per cash flow statement	-283	-33	-935	-3,107	-1,198	-1,135
add: dividends from associates	-	-	-	-	-	-
Other[1]	-1	-2	30	-	-	-
Funds from operations	**-185**	**1,720**	**3,987**	**-1,135**	**698**	**543**
Free operating cash flow in NOK m						
Funds from operations	-185	1,720	3,987	-1,135	698	543
Change in working capital	6	-33	5	-1	-1	-1
less: capital expenditure (net)	-258	-323	-186	-150	-400	-700
Free operating cash flow	**-437**	**1,364**	**3,806**	**-1,287**	**297**	**-158**
Net cash interest paid in NOK m						
Interest paid	28	20	23	34	38	17
Interest received	-7	-4	-53	-50	-28	-23
Net cash interest paid	**21**	**16**	**-30**	**-16**	**9**	**-6**
Scope-adjusted debt in NOK m						
Reported gross financial debt	1,368	919	622	622	319	319
less: cash and cash equivalents[2]	-66	-220	-4,179	-1,792	-1,365	-793
add: restricted cash[3]	-	-	200	200	200	200
add: pension adjustment	8	7	14	14	14	14
Other items	-	-	-	-	-	-
Scope-adjusted debt	**1,310**	**706**	**-3,343**	**-956**	**-832**	**-260**

[1] Other non-operative cash flows, changes in accruals, provisions etc
[2] Includes NOK 1.7bn in deposits in group cash pool and NOK 1.8bn in short-term financial assets
[3] Collateral for power trading activities on the Nord Pool exchange

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Environmental, social and governance (ESG) profile[4]

Environment		Social		Governance	
Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency)	Green leaf	Labour management		Management and supervision (supervisory boards and key person risk)	Grey leaf
Efficiencies (e.g. in production)		Health and safety (e.g. staff and customers)		Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate)	Grey leaf
Product innovation (e.g. transition costs, substitution of products and services, green buildings, clean technology, renewables)		Clients and supply chain (geographical/product diversification)		Corporate structure (complexity)	Grey leaf
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	Grey leaf

Legend

Green leaf (ESG factor: credit positive)
Red leaf (ESG factor: credit negative)
Grey leaf (ESG factor: credit neutral)

ESG profile supportive of market position, profitability, cash flow and access to liquidity

SKL's business model is aligned with ESG megatrends such as the increasing need for resource management, renewable energy, and emissions reduction. Although we do not have explicit emissions figures on SKL's generation, the Norwegian Institute for Sustainability Research has estimated that the average Norwegian hydropower plant has an average carbon footprint of less than 5g CO2e/kWh[5]. We therefore consider it likely that SKL's carbon intensity will be much lower than the European average of more than 250g CO2e/kWh. Such a strong position should support future cash flow and access to funding through high utilisation of SKL's hydro assets and should lower the risk of headwinds from regulation and political interference.

Regulatory and reputational risks evident in 2022

Despite having a positive sustainability profile, Norwegian utilities are still subject to regulatory and reputational risks. This became evident in September 2022 when the government imposed a temporary windfall tax because of soaring prices and permanently raised the resource rent tax on hydropower generation assets. This has increased our assesment of political risk, although we still consider the framework for utilities in Norway as stable.

SKL has issued several green bonds, and its green bond framework has received a 'Dark Green' opinion from CICERO.

[4] These evaluations are not mutually exclusive or exhaustive as ESG factors may overlap and evolve over time. We only consider ESG factors that are credit-relevant, i.e., those that have a discernible, material impact on the rated entity's cash flow and, by extension, its credit quality.
[5] https://norsus.no/wp-content/uploads/AR-01.19-The-inventory-and-life-cycle-data-for-Norwegian-hydroelectricity.pdf

Business risk profile: BBB-

Industry risk profile: BB

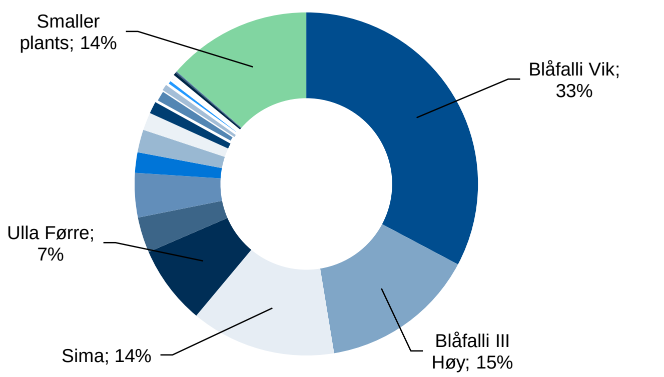
SKL is a pure-play power producer. We consider pure power generation to have high cyclicality and medium barriers to entry, which comes with a BB industry risk under our European Utilities Rating Methodology (details here).

Small power generator with efficient and flexible assets

SKL's total production in 2022 reached 2,317 GWh, 19 GWh above its mean production level. Associated power plants reported a production of 124 GWh, compared to a mean production of 142 GWh. The deviation from mean production for associated power plants was driven by three new power plants commissioned throughout 2022 and therefore did not contribute for the full year.

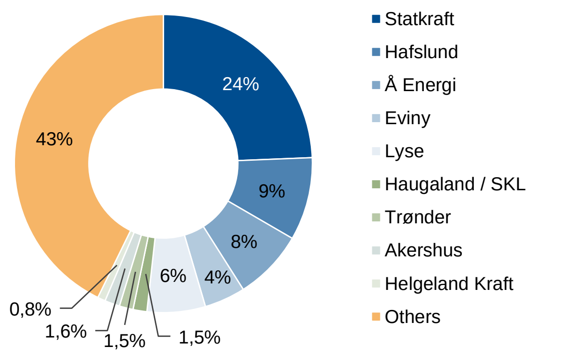
With an annual mean production of 2.3 TWh, SKL is a relatively small hydropower producer, accounting for an estimated 1.5%-2% of Norway's annual hydropower production in 2022. However, we still emphasise that size is of little importance for a utility's market position, with more weight given to factors such as merit order position, emissions, and adaptiveness of the generating assets. SKL's hydro power plants are favourably placed in the Nordic and European merit order systems, as exemplified by an estimated carbon intensity of less than 5gCO_2e/kWh (compared to the European average of 250g CO_2e/kWh). The plants are also highly profitable, with EBITDA margins of above 80% in 2021 and 2022. Lastly, the company can regulate around 50% of its annual mean production, which enables it to achieve above-market annual average prices by timing its production. This is credit-positive as it ensures flexibility in generation and the ability to optimise output when prices are high such as during peak-load hours. We anticipate that SKL will benefit more from this in the long term as the share of intermittent production in the Nordics and Europe is expected to increase.

Figure 2: Generating asset concentration (% of MW including "Småkraft"), FY 2022



Sources: SKL, Scope

Figure 3: Adjusted market shares, Norwegian hydro power producers, FY 2022



Sources: SKL, Scope

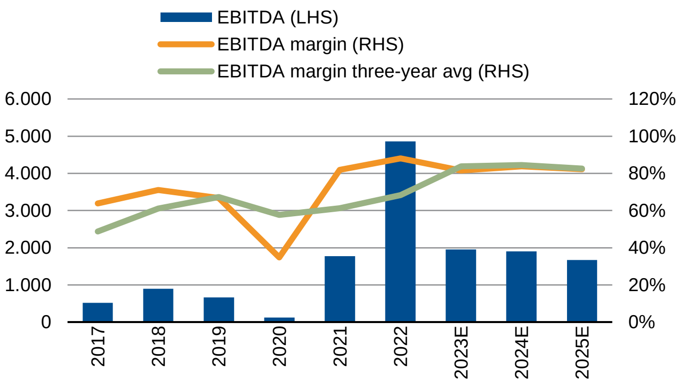
SKL's geographical diversification is limited compared to that of large European power producers and some local peers. The company is largely concentrated in the western part of southern Norway. While its power could virtually be sold anywhere within the Nord Pool market, price differentiation can also occur regionally. However, as SKL's price region is directly linked to the UK and Germany through two subsea cables, prices in the region have been higher and more stable in 2023 than for other Norwegian price regions. High prices have been driven by sustained foreign demand that helps dampen the effects of domestic supply/demand changes and/or changes in domestic hydrological balances. This could prove favourable in terms of diversification and could help to maintain high prices in the region.

High asset concentration

The diversification of SKL's power generation portfolio is still considered the weakest element of the business risk assesment, with the three largest hydro plants generating over 60% of its total production capacity.

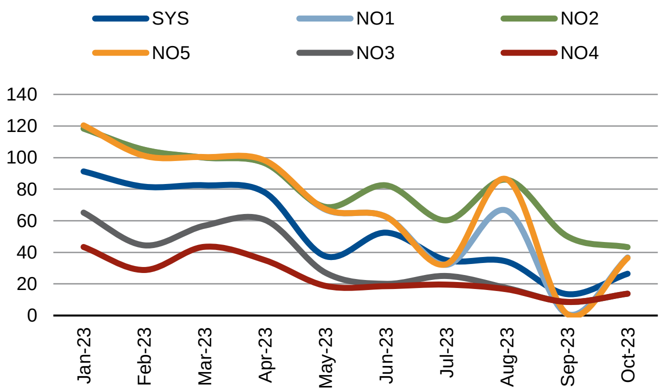
SKL has been seeking collaborations and strategic alliances. Recent examples are its offshore wind power project (Deep Offshore Wind) and hydrogen project (Hydrogen Solutions). Although these could increase diversification over time, they are not yet material enough to affect our current assessment.

Figure 4: Historical and expected profitability



Sources: SKL, Scope estimates

Figure 5: Monthly Norwegian spot prices by price region, as of October 2023 (EUR/MWh)



Sources: Nord Pool

Strong profitability as measured by EBITDA margin and Scope-adjusted return on capital employed

SKL reported a record-high EBITDA margin of 88% in 2022. This includes NOK 159m in windfall taxes recognised as other operating expenses, thereby reducing EBITDA. This is below our projected EBITDA margin of 96%, but still very strong and among the highest of all Scope-rated utilities. SKL's strong profitability is further supported by the recently introduced Scope-adjusted return on capital employed calculation, with a 2019-2022 average return on capital employed of 54%.

No hedge policy exposing SKL to significant volatility risk

SKL has a policy of not hedging its production. This allows the company to fully capitalise on market prices but also exposes it to significant volatility risk. This is exemplified by a poor performance in 2020 when prices were record-low, as well as its current performance as prices are relatively high. This is a constraining factor on its overall rating, but we cautiously acknowledge that the NO2 price region has had higher and more stable prices so far in 2023 than the other Norwegian price regions. The main reason for this seems to be the aforementioned subsea cables from NO2 to the UK and Germany.

Financial risk profile: A

Financial risk profile raised to A from BBB+

SKL's financial risk profile, raised to A from BBB+, is strong and supportive of its standalone credit assessment. The improvement in the past year has been driven by a stronger-than-expected end-2022 financial profile, with substantial cash and cash equivalents and limited interest-bearing liabilities, resulting in a strong net cash position. Based on a power price assumption of above EUR 70/MWh in 2023-2025 for NO2 coupled with SKL's unhedged and effective production, we now project a sustained strong performance. This will allow the company to maintain its end-2022 net cash position despite increased resource rent tax, continued dividends and one NOK 300m bond maturity in 2025. Given the high capex visibility, which mainly comprises the maintenance of hydropower assets, the main risk factors for weaker-than-forecasted credit ratios are lower power prices and more aggressive shareholder remuneration than assumed.

Assumptions and adjustments

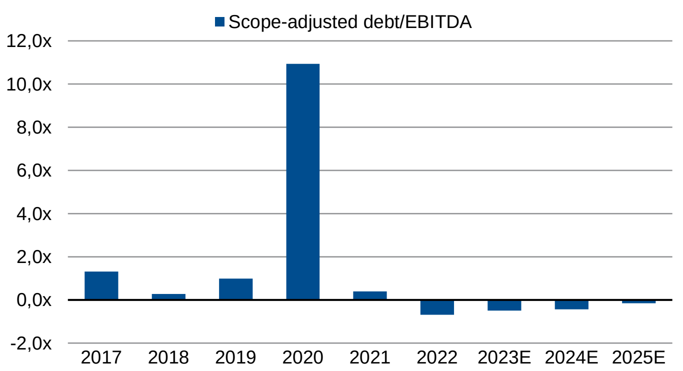
The main assumptions and adjustments in our updated base case are:

- Power prices to remain above EUR 70/MWh in NO2
- SKL to achieve annual prices 6% above the market by timing its production
- Annual production around mean production capacity, at 2.3 TWh
- Higher resource rent tax
- No windfall tax beyond 2023
- No refinancing of interest-bearing debt before 2025
- Dividends in line with the company's dividend policy
- Increasing capex throughout the forecast period, from NOK 150m in 2023 to NOK 700m in 2025

Projected strong metrics into the medium term

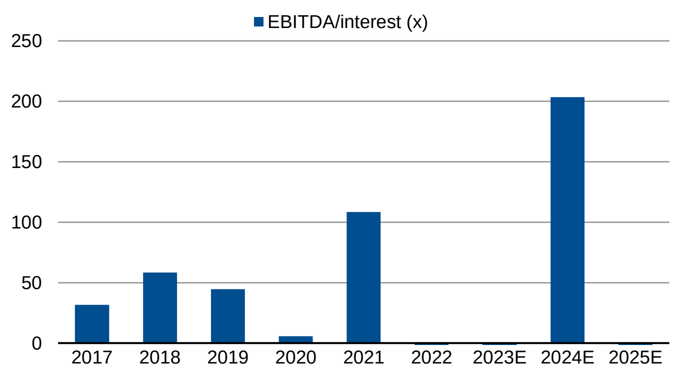
Because of moderate interest-bearing debt and substantial cash and cash equivalents that generate interest income, SKL reported a positive net interest in 2022. Our projections show positive net interest in 2023 and 2025 as well, driven by the same factors. We expect the Norwegian interbank rate (3M NIBOR) to peak towards the end of 2023 and for its full year effects to be visible in 2024. As such, 2024 is the only year with a projected negative net interest paid. We expect coverage to remain strong.

Figure 6: Leverage metrics



Sources: SKL, Scope (estimates)

Figure 7: Interest coverage*



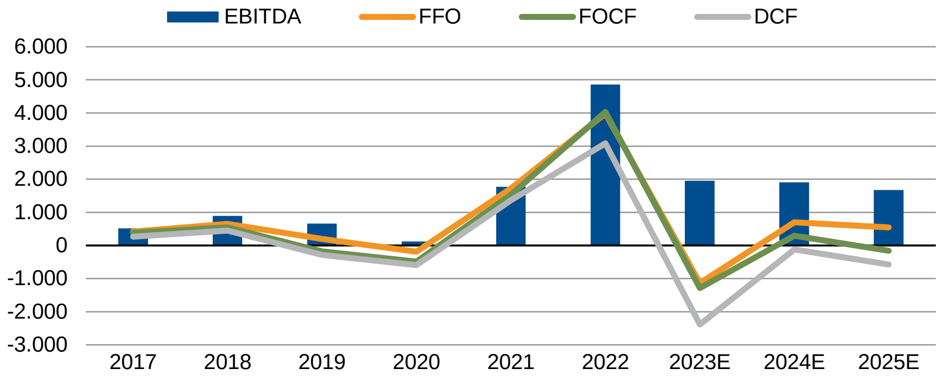
Sources: SKL, Scope (estimates)

*No coverage metric in 2022, 2023E and 2025E as net interest is projected to be positive

Tax-driven negative free operating cash flow projected in 2023E

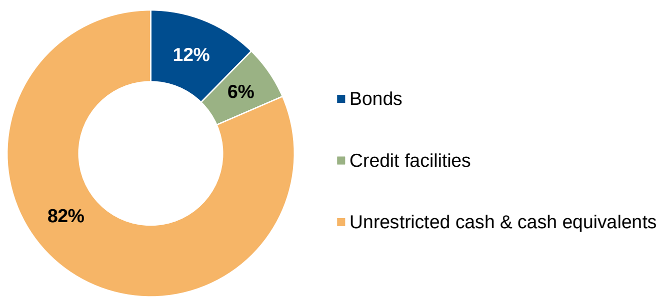
Given the timing of tax payments (one-year delay), we expect free operating cash flow to become negative in 2023, as an estimated NOK 3.1bn in tax payments based on 2022's performance is due. Further, free operating cash flow is expected to turn negative towards the end of our forecast period, driven by higher-than-historical investments and a declining price curve. However, with low debt and record-high earnings, SKL will likely be able to cover these payments through internal and external funding.

Figure 8: Cash flows



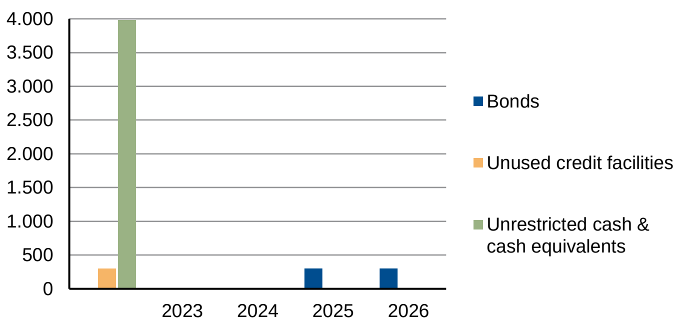
FFO: funds from operations
FOCF: free operating cash flow
DCF: discounted cash flow
Sources: SKL, Scope (estimates)

Figure 9: Funding mix, end-2022



Sources: SKL, Scope

Figure 10: Maturity profile, end-2022



Sources: SKL, Scope

Liquidity: adequate

Liquidity remains adequate, with substantial liquidity reserves, an unused NOK 300m committed credit facility and no current interest-bearing liabilities at end-2022.

SKL's end-2022 liquidity consisted of NOK 627m in cash reserves; NOK 1.7bn deposited in a group cash pool (at the Haugaland Kraft AS level); and NOK 1.8bn in short-term financial assets. This buffer will likely be used to service high tax payments for 2022, estimated at around NOK 3.1bn, which are due in 2023. We expect SKL to maintain this high internal financing capacity, supported by high operational profitability and limited investment opportunities in the medium term.

Balance in NOK m	2023E	2024E	2025E
Unrestricted cash (t-1)	3,979	1,592	1,165
Open committed credit lines (t-1)	300	300	300
Free operating cash flow	-1,287	297	-158
Short-term debt (t-1)	0	3	0
Coverage	**> 200%**	**> 200%**	**> 200%**

Supplementary rating drivers: +1 notch

No adjustment for financial policy

SKL's financial policy has no rating impact on its rating. Nevertheless, we note the relatively high payout in 2022, consisting of 80% of the preceeding year's net income, based on a strong performance in 2022. This deviates from the established dividend policy of 60% of the preceeding year's net income. While our base case incorporates a 60% payout ratio over the next few years, we acknowledge the possibility of extraordinary payments reoccurring based on the very strong projected financial profile.

Further, we note that the company aims to keep an investment-grade profile; thus, management will always adapt capex plans against this goal. As power price volatility has had a strong impact on results, SKL aims to maintain a strong equity ratio and pursues other internal credit ratio targets to withstand these swings.

One-notch uplift for SKL's indirect majority municipal ownership

We anticipate a medium capacity and willingness of the indirect municipal owners to provide support if needed, allowing a one-notch uplift on SKL's standalone credit rating, in line with our Government Related Entities Rating Methodology. Our assessment of the indirect majority municipal ownership of SKL is determined not by the standalone performance or credit quality of Eviny or Haugaland Kraft, but by their capacity and willingness to provide support if needed.

Long-term debt rating

Senior unsecured debt rating: BBB+

We affirmed the rating on senior unsecured debt at BBB+, the same level as the issuer rating.

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